Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

MACROCOSM

Oil's Bull Market in a Month

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Michael Warren and **Donald Luskin**

It turns out that everything the oil market thought it knew was wrong.

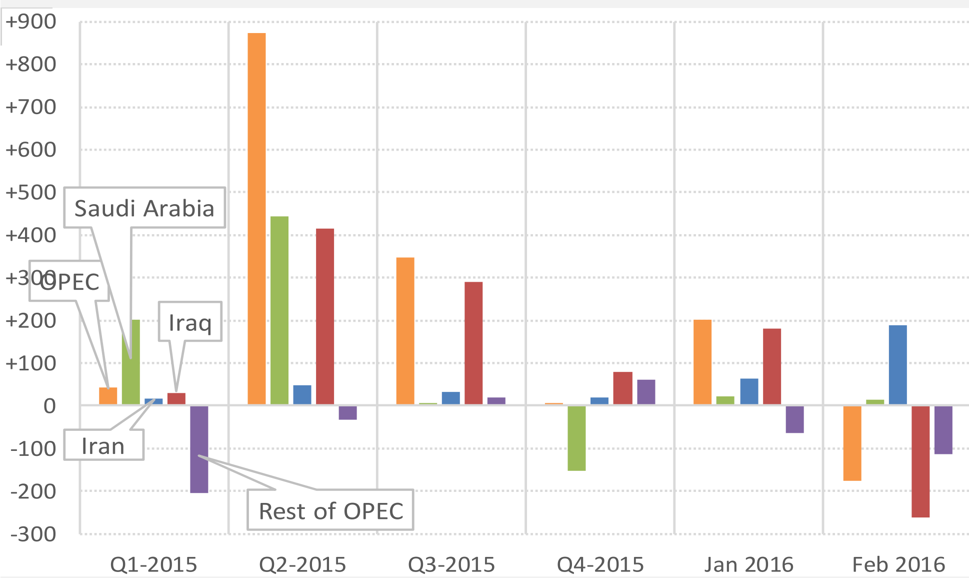
Oil prices have risen as much as 50% since our January 20 call for a "sloppy bottom" – remarkable, really, since it's all happened just since the *second* bottom of the double-bottom made on February 11, scarcely a month ago (see "Oil: Priced for Perfection in an Imperfect World" January 20, 2016). *It's been a bull market – in a single month.*

At this point, it's probably time for a correction. But the bottom is in. At both of the double-bottoms in January and February, oil was priced to perfection – and the bears like Goldman Sachs were howling for more, right at the bottom. Who knew? Oil lives in an imperfect world after all.

At the bottom, ***everybody knew*** *that Iran would flood the market after "Implementation Day" of the nuclear deal.*

- But Iran's oil minister Bijan Zanganeh, with his promise of 500,000 new barrels/day within weeks of lifting sanctions, looks now like Baghdad Bob. Now more than two months out, Iran's new exports

Change in crude production Millions barrels/day



Source: OPEC, TrendMacro calculations

Update to strategic view

OIL: Oil has rallied as much as 50% in little more than a month, since the second bottom of the double-bottom formed in January and February. This was the "sloppy bottom" we expected. It's probably time for a short-term correction here, but we think global oil prices will work back to our expected range of $45 to $60 over the year. At the bottom, oil was priced to perfection in an imperfect world. Iran's post-sanctions exports have disappointed. OPEC production is flat, while the cartel and Russia rattle sabers with talk, however silly, of a "freeze." Terrorism continues to imperil supply. And the mighty engine of US production has now definitively rolled over, with the worst yet to come.

are less than half that, as we had predicted way back when the deal was first struck (see "Iran: The New New World Oil Order, Volume I" July 20, 2015). Even Iran's cheerleader, the International Energy Agency, has had to admit it's been a big disappointment.

- Banking and logistical hurdles are hindering Iran's exports, as are difficulties in signing up long-term contracts. The only major deal that we know of is with Hellenic Petroleum of Greece, who agreed to import 120,000 barrels/day from Iran after reaching a settlement for the $650 million already owed to the National Iranian Oil Company.

*At the bottom, **everybody knew** that OPEC production would keep expanding infinitely, regardless of price.*

- But in fact it had already been flat in Q4-2015, and has, on net, been flat across January and February this year, even with Iran's return to the market (please see the chart on previous page).
- Saudi Arabian production has now been raised high enough to source its latest refinery complex. Saudi raised production by about 400,000 barrels/day last year from 9.6 million to 10 million to source a new refinery, achieving self-sufficiency in gasoline and diesel, and moving to capture diesel market share in European and African markets. In The Kingdom's long-term plan to move up the value chain from crude to product, there will be no need to exceed current production until late 2017 or early 2018, when the new Jazan refinery will come online.

*At the bottom, **everybody knew** that OPEC could never agree on production quotas to arrest the free-fall in prices since the cartel's late-2014 strategic shift toward market-share.*

- Indeed, such an agreement hasn't happened, and isn't likely to happen anytime soon. Even the much-vaunted possibility of an agreement, including non-member Russia, to freeze production at current levels – which the conventional wisdom has held out as the big explanator of the surge in oil prices over the last month – is a non-starter. Among other obstacles, Iran – struggling to regain market share now that sanctions have been lifted – regards such a freeze as "laughable."
- Nevertheless, Russia's diplomatic initiative for the freeze is, at least a trial balloon, and perhaps a meaningful shot across the bow. Perhaps having seen the effect on prices of just floating the idea – and that a mere freeze, not even a cutback – OPEC is learning about crude prices what central banks have always know about foreign exchange rates – they can be moved by threatening to intervene as effectively as by actually intervening.
- In an environment in which OPEC production has been flat now for five months anyway, this freeze initiative at least teaches markets they can't take the cartel for granted.

*At the bottom, **everybody knew** that oil would keep flowing, even as the*

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On the web at
trendmacro.com

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Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[About us]

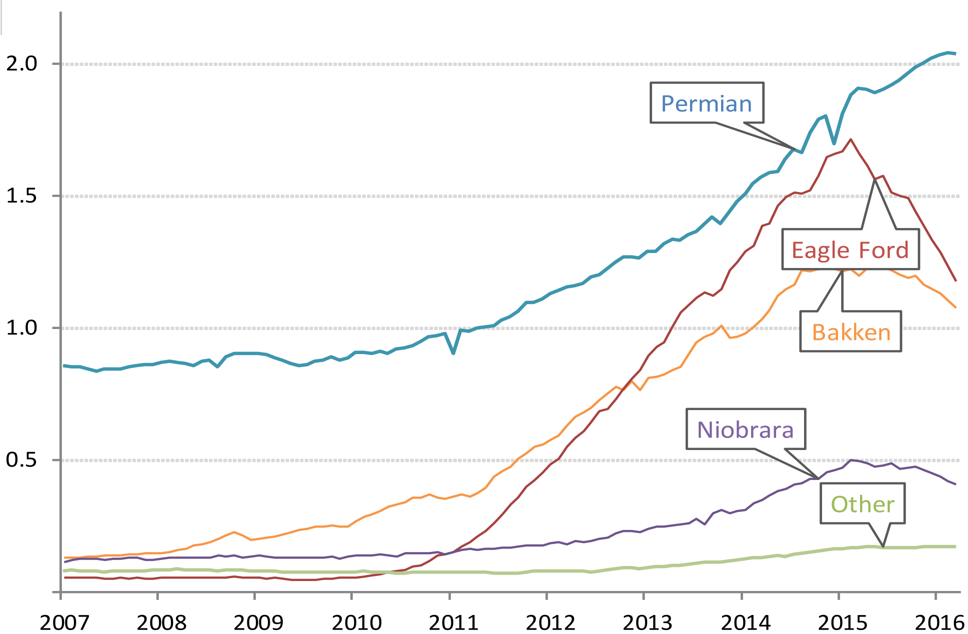
influence of terrorist organizations expanded in unstable oil-producing nations.

- Terrorist sabotage in Turkey, possibly by the Kurdistan Workers Party (PKK), is being blamed for the closure of an oil pipeline that used to transport up to 600,000 barrels/day to terminals in Ceyhan. This has cut back exports by the Kurdistan Regional Government in Iraq by 450,000 barrels/day, and by Iraq itself by150,000 barrels/day. This reversed almost an entire year in which resurgent Iraqi exports had been the brightest star in OPEC's galaxy. Reportedly the pipeline is now back in service as of today, but it's a stark reminder that regional instability remains a specter that haunts global oil markets.
- Nigerian production has been reduced by 15% since rebels in the Delta used a sophisticated underwater device to blow up oil pipelines linked to the Forcados oil terminal. Last year we warned that the newly elected Muslim president Muhammadu Buhari would fail to support the Christian faction whom the former Christian president had used to protect the pipelines (see "Saudisfaction Guaranteed" March 13, 2015). Buhari has no other option – his resources are tied down fighting the ISIS-linked terrorist group Boko Haram in the north.

*And now, to the elephant in the room. At the bottom, **everybody knew** that US frackers would somehow keep producing more and more oil, no matter how far market prices fell below their break-evens.*

- Not so. Shale oil production even in the mighty Permian has finally rolled over. It's now unanimous (please see the chart below, and "Data Insights: Oil" March 8, 2016).

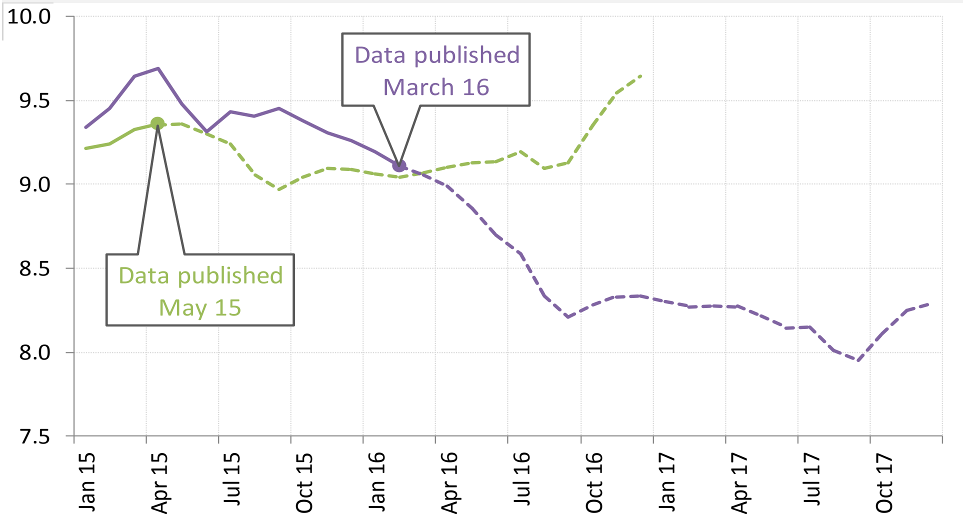
Oil production in major US shale plays Millions barrels/day



Source: DOE, TrendMacro calculations

- Yes, to be sure, we stand by our original vision: someday the exponential productivity improvements in fracking will make it possible to produce profitably at the low prices we saw at the double-bottoms in January and February (see, among others, ["The Shale Boom Shifts Into Higher Gear"]() June 1, 2015).
- *But not yet. With a 26-handle, WTI has found the supply-destroying price – at last.*
- Overall, US production from all sources can now be seen to have peaked in April 2015 (please see the chart below).

US crude oil production ▬ Actual --- Forecast Millions barrel/day



Source: DOE, TrendMacro calculations

- Since then, production is off 580,000 barrels/day, with 150,000 having come off just since year-end.
- At the April 2015 peak, US Department of Energy data correctly forecasted a rollover. Subsequent revisions kept April as the peak, but upwardly re-estimated volume at that peak by 340,000 barrels/day (please again see the chart above) – which created the market's misimpression that the US shale engine was unstoppable.
- As it turns out, even with the large upward revision, the subsequent rapid collapse has brought today's actual production almost exactly down to where DOE had predicted it would be back at the peak (please again see the chart above).
- *Most telling is the catastrophic downward revision in DOE's current forecast.* At the peak in April last year, DOE forecasted that production would return to peak by November 2016. Now DOE sees November 2016 at 1.15 million barrels/day *lower* than already-low current production. And then it gets even worse, production forecasted now for the first time to fall below 8 million barrels/day (one more time, please see the chart above).
- Aggressive cuts in CAPEX for 2016 are similar to last year's, and operators are saying that production will fall in 2016, having given flat or higher production guidance for 2015. Last year, production was maintained by some operators by drawing down the number of

wells in their "fracklogs" of wells drilled but not completed, and recompleting existing wells to eke out higher volumes. Hedges at high legacy prices sustained volumes, too. *Those are games that can't be played forever.*

- The downturn is affecting the entire industry, from the smallest operators drilling in the shale and light tight oil formations onshore to the largest integrated oil companies. Even ExxonMobil revised its production target down slightly, and said it would reduce CAPEX in 2017 after already having slashed its 2016 budget by 25%.
- Onshore US operators are worse off. For example, Whiting Petroleum, who tried to catch the falling knife by acquiring Kodiak as oil prices fell in the second half of 2014, has had to cut 2016 CAPEX by 80%, gave guidance that production would fall as much as 18%, and announced it will suspend completion of drilled by uncompleted wells.

While we've bragged a bit here about calling the double-bottom at WTI $26, we're well aware that we had wrongly called the bottom before. We admit we didn't expect prices to get as low as they did in this cycle. *When a bear market has acquired as much momentum as this one did, in the final throes it's simply in the hands of the gods. So we're humbled by the challenge now of forecasting how much further prices can recover.*

- Even as the global economy has weakened into the New Year, we haven't seen a significant drop in petroleum demand.
- With oil prices having bottomed – permitting a narrowing of credit spreads and an easing of bank stability concerns – we expect that the macro environment can stabilize and improve from here (see "Have We Suffered Enough?" February 26, 2016).
- In other words, with oil prices having irreparably damaged the global economy by not staying way too low for way too long, a recovering oil price poises the global economy to recover – which, in turn, encourages oil prices to recover further.
- There can't be a lot of science in this. But wetting our finger and putting it into the wind, we have to stick with our long-standing expectation that global oil prices will gradually work back into the $45 to $60 range over the rest of the year.

Bottom line

Oil has rallied as much as 50% in little more than a month, since the second bottom of the double-bottom formed in January and February. This was the "sloppy bottom" we expected. It's probably time for a short-term correction here, but we think global oil prices will work back to our expected range of $45 to $60 over the year. At the bottom, oil was priced to perfection in an imperfect world. Iran's post-sanctions exports have disappointed. OPEC production is flat, while the cartel and Russia rattle sabers with talk, however silly, of a "freeze." Terrorism continues to imperil supply. And the mighty engine of US production has now definitively rolled over, with the worst yet to come.